Conclusion

for over 22 years mutual fund shares were valued in the same manner as other securities. The Commissioner now seeks to upset this long settled rule by means of a regulation so totally at variance with existing methods of valuing securities that [illegible] to put it in the same class with them. This regulation would tax mutual fund shares at a value which the estate could never realize under any circumstances.

This is a flagrant example of bureaucratic legislation which recalls the words of Mr. Justice Douglas in *Commissioner v. [illegible]*, [illegible] U.S. [illegible]:

"Resort to litigation rather than to Congress, for a change in the law, is too often the temptation of government which has a longer purse and more endurance than any taxpayer."

The decision of the Court below should be affirmed.

Respectfully submitted,

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INDEX

CITATIONS

Cases:

IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 71-1665

UNITED STATES OF AMERICA,

Petitioner,

—v.—

DOUGLAS B. CARTWRIGHT, as Executor of the Estate of ETHEL B. BENNETT.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE INVESTMENT COMPANY INSTITUTE AS *AMICUS CURIAE*

Opinions Below

The opinion of the court of appeals is reported at 457 F.2d 567 and the opinion of the district court at 323 F. Supp. 769.

Question Presented

Whether Section 20.2031-8(b) (1963) of the Treasury Regulations on Estate Tax (1954), which requires that shares of open-end investment companies (mutual funds) should be valued for estate tax purposes at the public

offering or asked price (which includes an 8% sales commission), instead of at net asset value (the bid price or the amount actually paid by the fund to the investor or his estate on redemption) is a reasonable regulation.

Statutes and Rules Involved

In addition to the pertinent provisions of the Internal Revenue Code of 1954 and the Treasury Regulations on Estate Tax thereunder, set forth in Petitioner's Appendix* (Pet. Br. pp. 23-27), we set out in the ICI Appendix *infra*, pp. 27-37, pertinent provisions of the Investment Company Act of 1940, c.686, 54 Stat. 789 as amended, 15 U.S.C. 80a-1, et seq. and related Rules.

Statement

The Government appeals from a decision of the court of appeals, affirming the district court's finding that Section 20.2031-8(b), of the Treasury Regulations on Estate Tax, which requires that shares of an open-end investment company (mutual fund) be valued for estate tax purposes at the public offering (asked) price (i.e., net asset value plus sales commission), instead of at net asset value or bid price (the price actually paid on redemption by the fund to the estate), is invalid.

The Government argued that the challenged regulation is in accord with general principles of valuation contained in Sec. 20.2031-1(b) of the Regulations which states that

* References to Appendices are hereinafter designated as follows: Joint Appendix (J.A.); and Investment Company Institute Appendix (ICI App.). Petitioner's brief is designated Pet. Br.

"fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell . . ." and that therefore the replacement cost of the fund shares ("public offering price")—including the sales commission (or "load")—are properly included in the value of these shares for estate tax purposes under the provisions of Sec. 20.2031-8(b).

As justification for the Regulation, the Government analogized the valuation of mutual fund shares to the method of valuation of single payment life insurance policies approved by this Court in *Guggenheim* v. *Rasquin*, 312 U.S. 254. It is argued that mutual fund shares have a value beyond their redemption price, which is reasonably reflected in the added commission charge. The Government claims its regulation is reasonable and must, therefore, be accepted by the courts, despite the existence of other alternative methods of valuation. *United States* v. *Correll,* 389 U.S. 299, 306-307.

The court of appeals and the district court found the regulation unreasonable and the Government's analogy to single payment life inapposite. They found that the Government's theory of valuation did not accord with the way in which fund shares are actually bought and redeemed, especially the important role of guaranteed redemption at any time by the fund at the then current net asset value. Both courts held the addition to the redemption price of a commission charge and the assignment of a value for estate tax purposes in the amount of the commission over and above the redemption price, a value which the estate can never realize in any market and which was never a part

of the net assets of the fund, was an invalid exercise of power.

The court of appeals emphasized the principle of valuation included in Sec. 20.2031-1(b) that "All relevant facts and elements of value as of the applicable valuation date shall be considered in every case."

The court concluded:

> We would agree . . . that the retail sales price of a property unit may be an important factor in the determination of its fair market value; yet it is also clear that other factors can affect the price which a willing seller reasonably could expect to receive from a sale of that particular unit, and if these other factors cause the retail price to be an unreasonable or unrealistic value standard, the retail price has not always been followed in valuation disputes as the sole criterion of value. (457 F.2d at 571) (footnote omitted).

Neither the realities of the mutual fund business nor the scheme of regulation under which it functions support the Government position.

The pattern of regulation under the Investment Company Act, c. 686, 54 Stat. 789 (15 U.S.C. 80a-1 et seq.) ("1940 Act" or "Act"), especially the provisions for redemption under Section 22(e) (15 U.S.C. Sec. 80a-22) and related provisions of the Act, fully support the conclusions of the courts below that it would be unreasonable to include the commission (or sales "load"), charged for the acquisition of fund shares, as a part of the value of those shares for estate tax purposes.

Interest of the Investment Company Institute as *Amicus Curiae*

The Investment Company Institute includes in its membership 378 open-end investment companies (mutual funds) registered under the 1940 Act, accounting for approximately 90% of the industry's assets and 8.5 million shareholders.

The position of the Government imposes an additional tax burden on the millions of mutual fund shareholders who will leave fund shares as part of their estates. It imposes a tax penalty unanticipated by Congress, fund distributors or investors who bought fund shares for investment and retirement purposes.

The addition of the sales commission charge to the redemption (net asset) value for estate tax purposes creates an artificial incentive to early redemption while the investor is alive, and is therefore harmful to the best interests of fund shareholders.

The Government's position unfairly discriminates against funds charging sales commissions (load funds) and favors no-load funds, closed-end funds and individual stocks and bonds as investment vehicles. It makes mutual funds a less attractive investment and disadvantages fund investors.

The national public policy as expressed by the 1940 Act is to provide a well regulated industry for the management of investors' money.

The Securities & Exchange Commission itself has recognized

> . . . the fact that by offering the American public a medium for professionally managed investment in se-

curities, primarily the stocks of America's leading companies, the investment company industry, and specifically mutual funds, fulfill an important public need. The industry has earned its place as an important component of our Nation's financial community.[1]

The Investment Company Institute here seeks to avoid the imposition of an unfair and arbitrary tax burden on mutual fund shareholders and the elimination of an unwarranted and significant discrimination in estate tax treatment against mutual funds sold through distributors charging sales commissions.

Summary of Argument

1. Mutual fund shares are by statutory definition "redeemable" (Sections 2(a)(32), 22(e), 1940 Act) and that Act requires that funds stand ready to redeem their outstanding shares at the request of any shareholder. Such redemption is made at the then current net asset value, which does not include any sales commission. (Section 2(a)(32)). The only practical way for a shareholder to redeem is to tender his shares to the fund. Commission (sales) charges on the purchase of fund shares are fixed and paid to the sales organization when the shares are purchased. (Section 22(d)). The sales commission is never a part of the fund's net assets.

2. The Government seeks to value fund shares for Estate Tax purposes, under Section 20.2031-8(b) of the Treasury Regulations, at the public offering price, i.e. the net asset value *plus* sales commission. The Government's posi-

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[1] SEC, *Report on Public Policy Implications of Investment Company Growth*, H. Rep. No. 2337, 89th Cong., 2d Sess. (1966), letter of transmittal of Chairman Cohen, at p. vii ("SEC PPI Report").

tion, that the value of such shares should include sales commission is based on "replacement value". Since a shareholder seeking to purchase such shares would have to pay the public offering price, which includes a commission, the Government argues that the offering price is the correct value of the shares. This view is contrary to the regulations applied to the valuation of other corporate stock, including listed and unlisted stock, closed-end investment companies and no-load mutual funds. No reasonable basis exists for such a distinction either in the regulatory scheme or the realities of the market.

3. The Government's analogy to single payment life insurance (citing *Guggenheim* v. *Rasquin*, 312 U.S. 254) is wholly inappropriate. Mutual funds are clearly unlike life insurance policies (*SEC* v. *Variable Annuity Co.*, 359 U.S. 65) and should be valued instead like other shares of corporate stock, not life insurance policies to which they bear no legal or realistic resemblance. Analogy to the new issuance of stock offered to the public through an underwriter, before a trading market has been established, is similarly without reasonable basis, as the SEC's 1966 mutual fund study (SEC PPI Report, *supra*, note 1) makes clear. Every reasonably analogous valuation situation demonstrates that the Government is unfairly singling out mutual fund shares sold through brokers or sales organizations for discriminatory treatment which disadvantages fund shareholders in determining value for Estate Tax purposes.

4. Even the application of the willing buyer-willing seller standard does not support the Government's view since the initial purchase agreement, made between the fund as a willing seller and the purchasing shareholder as a willing buyer, includes the right to redeem at net asset value at any time the shareholder wishes to do so.

ARGUMENT

The valuation of mutual fund shares for Estate Tax purposes at the public offering price (which includes the sales commission) instead of net asset value (the amount actually realizable on redemption by the investor or estate) applies the "willing buyer-willing seller test" in an unreasonable manner, which ignores the effect of relevant provisions of the 1940 Act, the realities of industry practice and the understanding of the parties and unfairly analogizes the sale of fund shares to single payment life insurance policies instead of corporate stock or similar investment securities.

A. *Introduction: The 1940 Act and the Regulatory Pattern, Industry Practice and the Expectation of Investors*

The two unique aspects of mutual funds that distinguish them from other investment media and have "substantially contributed to the growth of the industry . . . are the redeemability of mutual fund shares and their continuous offering to the public."[2]

In considering the issues involved in this case it is important to set out the regulatory scheme which defines the terms and sets the standards under which the mutual fund industry operates. An investment company is defined by the 1940 Act as one in which a number of investors have pooled their resources to engage in the business of investing, reinvesting or trading in securities.[3] The Act

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[2] Securities and Exchange Commission, Special Study of Securities Markets, Ch. XI, Open-End Investment Companies, H. Doc. No. 95, Pt. 4, 88th Cong., 1st Sess., at 95-96 (1963) ("Special Study").

[3] Sections 3(a)(1)-(3).

then classifies the various types of investment companies; the most important grouping in terms of size and number of investors is the management companies.[4] Management companies are in turn divided into closed-end and open-end companies, the latter are generally known as mutual funds.[5] A mutual fund is defined as one that "is offering for sale or has outstanding any *redeemable security* of which it is the issuer."[6] Section 2(a)(32) defines "redeemable security" as any security under the terms of which the holder may present it to the issuer and be entitled to receive "his proportionate share of the issuer's current net assets, or the cash equivalent thereof."

Mutual funds are required by Section 22(e) of the Act, as well as their underwriting agreements and corporate charters to be continuously ready to redeem their outstanding shares upon tender by any shareholder.[7]

The Special Study explained the basic manner in which mutual fund shares are sold:

> Mutual fund shares are not traded on exchanges or generally in the over-the-counter market, as are other

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[4] See Section 4.

[5] Section 5.

[6] Section 5(a)(1). (Emphasis added.)

[7] Section 22(e) prohibits a registered mutual fund from suspending the right of redemption or postponing payment for more than seven days after the tender, except in the case of certain emergencies. The Stipulation of Facts in this case states: "12. As stated in each prospectus, the certificate of incorporation of each of these investment companies gives each registered shareholder the right to require the investment company to redeem his shares at any time at the redemption price described in the prospectus. Although there are no restrictions on the transferability of shares of these investment companies, the shareholders ordinarily dispose of them by requesting the company to redeem them" (J.A. 25).

securities, but are sold by the fund through a principal underwriter, and redeemed by the fund, at prices which are related to "net asset value." The net asset value per share is normally computed twice daily by taking the market value at the time of all portfolio securities, adding the value of other assets and subtracting liabilities, and dividing the result by the number of shares outstanding. Shares of most funds are sold for a price equal to their net asset value plus a sales charge or commission, commonly referred to as the "sales load," and usually ranging from 7.5 to 8.5 percent of the amount paid, or 8.1 to 9.3 percent of the amount invested. A few funds, however, known as "no-load" funds, offer their shares for sale at net asset value without a sales charge. Shares of most funds are redeemed or repurchased by the funds at their net asset value, although a few funds charge a small redemption fee. The result of this pricing system, it is apparent, is that the entire cost of selling fund shares is generally borne exclusively by the purchaser of new shares and not by the fund itself. In this respect the offering of mutual fund shares differs from, say, the offering of new shares by a closed-end investment company or an additional offering "at the market" of shares of an exchange-listed security, where at least a portion of the selling cost is borne by the company selling the shares.[8]

Fund shares are sold to the public through principal underwriters pursuant to underwriting contracts with the

[8] Special Study, *supra*, at 96-97 (footnote omitted); see also, SEC PPI Report, *supra*, at 41-43, 51-56.

funds[9] (as Investors Diversified Services ("IDS") has in this case); these underwriters receive the entire commission (or load) on sales and retain it or reallow a portion to fund salesmen or brokers, depending on whether their sales force is fully integrated (or "captive") (as is the situation in IDS) or whether shares are sold through independent brokers. (See description, Special Study, Ch. XI, *supra*, at 102-107.) As the Special Study points out, the load goes to the sales organization, not to the fund. It never becomes a part of the fund's net assets. (*Id.* at 96-97, 107-9.)

The sales organizations must sell to the public at the predetermined public offering price, that is net asset value plus a set commission or load which is fixed for each fund. The level of commission is fixed pursuant to Section 22(d) of the Act, which in effect provides for retail price maintenance in the sale of fund shares. Thus, the sales price of fund shares is not negotiated. The net asset value is determined daily by dividing the value of the stock and other assets in its portfolio by the number of shares outstanding; the fixed sales commission is added to that price. Section 22(b) of the 1940 Act also authorizes the National Association of Securities Dealers (NASD) to prohibit its members from purchasing fund shares from any mutual fund or its principal underwriter at any price other than the public offering price, less a discount (computed under its rules). The NASD forbids the sale of fund shares by principal underwriters at a discount from the public offering price to anyone other than a dealer who is an NASD member, and then only pursuant to an existing sales agreement set-

[9] Section 15(a)-(c) imposes certain requirements respecting these contracts including approval by the board of the fund and termination provisions.

ting forth the concession.[10] The sales agreements provide that the selling dealer must sell at net asset value plus the fixed sales charge and no less.[11] Rule 2a-4 under the 1940 Act (ICI App. pp. 34-35) defines "current net asset value" for use in computing the current price of a redeemable security.

In sum, the essential conditions of the sale of mutual fund shares are controlled under the 1940 Act, which requires that fund shares be sold, pursuant to selling agreements with principal underwriters,[12] who act as agents for the fund and receive a fixed percentage of the selling price as their commission (Section 22(d)). Such commissions do not become part of the fund's assets.[13] The Act requires (Section 22(e)) and its prospectus represents that the fund stands ready (through its underwriter) to redeem shares at net asset value (as defined under the Act) and that this contractual right is protected by federal law. The fund cannot redeem at any price more than net asset value or the remaining shareholders would be illegally diluted. (Sec. 2(a)(32)). Redemptions are almost always accomplished by tendering to the fund or through its agent.[14]

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[10] NASD Rules of Fair Practice, Art. III, Section 26(c) (ICI App., pp. 36-37). See discussion in Special Study at pp. 98-99.

[11] Special Study, at 98.

[12] Section 15(a)-(c).

[13] The sales commission should be clearly distinguished from the management (or advisory) fee which is usually approximately .5% annually, which is periodically paid out from the fund directly to the fund's manager (or adviser) pursuant to a management contract between the manager (or adviser) and the fund pursuant to Section 15 of the Act.

[14] See SEC PPI Report, p. 42.

B. *The Initial Purchase Agreement, Made Between the Investor as a Willing Buyer and the Fund, Through Its Underwriter, as a Willing Seller, Includes the Right of Redemption*

The Government argues that the only time that the willing buyer-willing seller situation exists in the sale of fund shares is at the time of the original sale. (323 F. Supp. at 772) (See Pet. Br. 10-11). The redemption, it is argued, is under compulsion or obligation and thus, not willing on the part of the fund. The argument misconceives a basic element in the sale of fund shares—that *at the time of purchase* the investor and the fund agree, without compulsion, that the investor (or his estate) can at his option redeem his shares at net asset value at any time in the future. The Stipulation of Facts in this case (see note 7, *supra*) specifically recognizes that, "as stated in each prospectus, the certificate of incorporation . . . gives each . . . shareholder the right to require the investment company to redeem his shares at any time at the redemption price described in the prospectus" (J.A. 25). Thus, the redemption feature is built into the fund shares from the beginning and it is unrealistic to picture the fund as an *unwilling* purchaser at the time of redemption. This segmented reasoning neither comports with the provisions of the 1940 Act, the undertakings of the parties nor the reality of fund sales operations (J.A. 50). The district court correctly found that:

> . . . at the time of original purchase, the buyer is fully aware that, at the time of sale back to the company, he will be able to sell the shares back at the net asset value or redemption price, whatever it may be at that time. At the time of original purchase, both the buyer

and seller are fully cognizant of the facts and willingly enter into the transaction (323 F. Supp. 772).[18]

Thus, even under the willing buyer-willing seller test, the value to the estate should be net asset value because the redemption is the result of a sale made by a willing buyer to a willing seller, which sale included the right to redeem at any time at net asset value. The investor can, as a practical matter sell his shares only to the fund at a price that is not open to speculation, but is specifically calculated under the 1940 Act to reflect the true value of the shares.

The court of appeals correctly referred to the "strikingly similar" situation where Treasury Regulation 20.2031-2(h) requires that the value of shares of corporate stock subject to a restrictive agreement that they cannot be sold unless first offered to the corporation itself (or to another) at a specific price, if agreed upon in an arm's length transaction, is the price so specified and not the public market price available on an exchange (457 F.2d at 571).

Certainly, the mutual fund purchase agreement, which includes not only a contractual agreement to redeem (sell the shares back to the corporation) at the investor's option, but a statutory obligation to do so, at a specific price (then existing net asset value), is clearly within the reasoning

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[18] Similarly, in *Davis v. United States*, 460 F.2d 769, 772 (CA 9, 1972) the court of appeals stated:

> . . . As a practical matter for determining value, however, the redemption market is the market upon which both parties agree when the shares are purchased. The mutual fund chooses to operate in such form under the law and the public buys shares in the fund fully apprised of its redemption opportunities through company prospectuses.

which applies to such restrictive agreements to resell to a corporation.[16]

C. *The Rejection of Valuation of Single Payment Life Insurance at Cash Surrender Value in* Guggenheim v. Rasquin, *312 U.S. 254, Does Not Control Valuation in the Case of Mutual Fund Shares*

The decision in *Guggenheim, supra,* relating to the value of a single payment life policy should not control here. In that case this Court held the payment of $852,438 for a fully paid life policy, with a face value of $1 million, could not be realistically valued at the cash surrender value of $717,344. The rule in *Guggenheim* would in no way be undercut by a ruling that mutual fund shares should be valued at their redemption (bid) value rather than at the redemption price plus sales commission (asked).

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[16] The district court in *Davis* v. *United States*, 306 F. Supp. 949, 955 (C.D. Cal., 1969), *aff'd*, 460 F.2d 769 (CA 9, 1972) commented:

> Although there is no binding contract in this case, the rationale of Treas. Reg. 20.2031-2(h) (1958) should apply to the open-end investment shares because the redemption price offered by the company truly represents the only realistic value that the estate can obtain for the shares of the open-end investment company. Cited with approval by the court of appeals herein, 457 F.2d at 571, n. 7.

It is not at all clear that no binding contract exists in the fund situation. An investor would clearly have a cause of action under Sec. 22(e) of the 1940 Act as well as under the charter and prospectus representations of the fund if redemption were refused. See cases upholding private rights of action for violations of other Sections of the 1940 Act. *Brown* v. *Bullock,* 194 F. Supp. 207 (SDNY), *aff'd,* 294 F.2d 415 (CA 2, 1961); *Levitt* v. *Johnson,* 334 F.2d 815 (CA 1, 1964), *cert. denied,* 379 U.S. 961 (1965); *Chabot* v. *Empire Trust Co.,* 301 F.2d 458 (CA 2, 1962); as well as other provisions of the federal securities laws. E.g., *J. I. Case Co.* v. *Borak,* 377 U.S. 426, 432 (1963); *Sup't of Insurance* v. *Bankers Life & Casualty Co.,* 404 U.S. 6 (1971).

The inappropriateness of the single payment life analogy was fully discussed by the courts below (323 F. Supp. at 772-73, 457 F.2d at 570-71; and in *Davis* v. *United States*, 306 F. Supp. at 956; 460 F.2d at 772).

This Court in *Guggenheim* pointed out that "the owner of a fully paid life insurance policy has more than the mere right to surrender it; he has the right to retain it for its investment virtues and to receive the face amount of the policy on the insured's death." 312 U.S. at 257.

The court of appeals in *Davis, supra,* concluded:

> Had the insured died the day after issue, the policy would have matured at $1,000,000. Based on actuarial tables, its cash surrender value was considerably less. Along with this value uncertainty were other values likewise imprecise. We cannot equate the valuation of shares in a mutual fund with the necessarily abstract valuation of a single premium life insurance policy. On any given day, the net value of the mutual fund shares may be computed exactly (460 F.2d at 772).

The Government argues (Pet. Br. 16-19) that mutual fund shares are more like life insurance policies than shares of corporate stock, whose value for estate tax purposes does not under Section 20.2031-2(b) include the broker's commission necessary to purchase these securities through an exchange member or an over-the-counter broker. The Government acknowledges that listed stocks are valued under Section 20.2031-2 at the mean between the highest and lowest quotations on the date of death. *This value does not include the fixed commission charge imposed by all*

exchange member firms on the purchase or sale of listed securities. Inexplicably the Government argues that this "is entirely consistent with the regulation under attack here, because the quoted price of a listed stock, like the asked price of a mutual fund, is the amount which a willing buyer pays to a willing seller" (Pet. Br. 18). The Government seems to ignore in its determination of value of listed stock the fact that in both cases—listed stock and mutual fund shares—replacement of the shares in the estate by purchase on the market would require the payment of a fixed brokerage commission.[17]

It was argued below that the estate could continue to own the fund shares for investment purposes, including the possibility of receiving capital gains and dividend distributions. The court of appeals correctly observed that:

> This argument applies with equal force to the shares of numbers of corporations listed on the stock exchanges, not only to the mutual fund shares. Clearly, the com-

[17] Thus, for stocks listed on the New York Stock Exchange (in purchases involving less than $300,000) this involves a fixed commission to the broker over and above the market or quoted price. See Constitution of the NYSE, Art. XV, Secs. 1, 2 and 7, discussed in Securities Industry Study, Report of the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Ch. III, pp. 53-56 (Feb. 4, 1972). Moreover, since brokers would also require payment of commissions to purchase or sell OTC stock, there is no real difference in substance from the situation involving listed securities (Pet. Br. 19 n. 14) and the same inconsistency appears. See, Special Study, *supra*, note 2, for a discussion of the operation of the stock exchange commission rate structure, Ch. VI, I., especially pp. 295-97 on non-member commissions and Ch. VII, A-D I, discussing the operation of the over-the-counter markets, especially pp. 624-27 on the costs of execution for retail customers. The implementation of volume discounts and negotiated rates above $300,000 in listed securities and the continued existence of negotiated commissions on OTC transactions does not alter the situation in the context of this case.

missions paid to brokers when shares in these companies are bought or sold are not in payment for, or a measure of, the value beyond the resale price, but are rather simply compensation to the broker for his services. (457 F.2d at 570)[18]

Life insurance policies are clearly distinguishable for valuation (as well as basic regulatory) purposes from stocks and bonds traded on the exchanges and in the securities markets. That difference was recognized in *Guggenheim*, where this Court pointed out that:

> [A]n important element in the value of the property is the use to which it may be put. Certainly the petitioner here did not expend $852,438.50 to make an immediate gift limited to $717,344.81. Presumptively the value of these policies at the date of the gift was the amount which the insured had expended to acquire them. (312 U.S. at 257-58).

The question here is whether mutual fund shares should be treated like corporate stock or like life insurance policies. The important distinctions between life insurance and mutual funds have come before this court before. *SEC v. Variable Annuity Co.*, 359 U.S. 65 (1959) ("VALIC"); *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967) ("United Benefit").[19] These cases make clear that insur-

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[18] Citing with approval the dissent of Judge Tannenwald in *Wells v. Commissioner*, 50 T.C. 871, 880 (1968) *aff'd* sub nom. *Ruehlmann v. Commissioner*, 418 F.2d 1302 (CA 6, 1969) *cert. denied*, 398 U.S. 950 (1970).

[19] See also: *Prudential Ins. Co. of America v. SEC*, 326 F.2d 383 (CA 3), *cert. denied*, 377 U.S. 953 (1964); hearings before the SEC, *In the Matter of American Life Convention, et al.* (File No. 4-149) (1972) (pending decision on rule making re variable life insurance and possible exemptions from the 1940 Act).

ance policies do not have the same characteristics as mutual fund shares and that investment companies, even when they are promoted as separate accounts by insurance companies, will not be permitted to escape regulation under the 1940 Act. If life insurance was really as similar to mutual funds as the Government seems to argue then the distinctions made in *VALIC* and *United Benefit* would not be meaningful. Whatever the problems when distinctions become blurred by remolding of the insurance product, it is certainly clear that mutual fund shares are not treated like true life insurance for substantive purposes, like federal regulation under the 1940 Act, that they have very distinct and separate characteristics and that in fact, mutual fund shares are, as the court of appeals found, more similar to corporate stock. (457 F.2d at 570-71). Fund shares are, after all, shares in an investment company, which (as in this case) is itself a corporation. Its value is determined by the performance of its portfolio securities and the value fluctuates from day to day. It has no fixed or guaranteed value. An investor may purchase mutual funds regardless of his health and at any age. There is no problem of eligibility such as that posed by uninsurability. As the district court noted in this connection:

> The bundle of rights in *Guggenheim* included the right to receive the face value of the policy at the time of death, and a certainty of insurance coverage if Mrs. Guggenheim became uninsurable.
>
> * * * * *
>
> No doubt there are advantages in holding mutual funds, but mutual funds and insurance policies are so different that the bundle of rights in each cannot be

> compared. . . . Because it is difficult for many individuals to obtain life insurance coverage, the purchase of a life insurance policy is a valuable right. There is no comparable consideration in the purchase of mutual fund shares. (323 F. Supp. at 773)[29]

Under the Government's view, shares in a closed-end investment company, whether listed on an exchange or not, are valued (as are corporate stocks) at the price the estate will realize on the sale of the shares, not what it would have to pay to replace the shares if bought through a broker (market price plus a brokerage commission). Shares of an open-end company, however, are valued at net asset value plus commission. Such disparate treatment is unreasonable; both entities are investment companies, the open-end fund has a precisely determinable market value and both kinds of shares normally involve fixed brokerage commissions. The closed-end shares are sold through the New York Stock Exchange (or over-the-counter if they are not listed) and would require payment of a commission to replace. The distinction in treatment imposed by the Government is not sound.

Similarly, and even more closely in point, a no-load fund bought by the same person would obviously be valued at net asset value, yet the bundle of rights in the hands of the investor (or the estate) is exactly the same in a no-load

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[29] An examination of "the bundle of rights" involved in a single payment life policy as against the bundle involved in the purchase and ownership of mutual funds is certainly appropriate. See concurring opinion of Mr. Justice Brennan, in *VALIC*, 359 U.S. 77-80 and *SEC* v. *United Benefit Life Ins. Co.*, 387 U.S. 202, 205-209, 212. The courts below engaged in just such an analysis and correctly viewed mutual fund shares as more clearly analogous to corporate stock, not life insurance or annuities.

as in a load fund. The Government's interpretation advantages no-load investors over load fund investors in a way never contemplated by Congress. Such treatment merely demonstrates the aberrational results derived from application of the Government's interpretations. Certain no-load funds, as indicated by the record (J.A. 66), impose a 1% redemption charge. Presumably, not only would an estate holding such shares not be assessed a sales load of 8%, but would be entitled to deduct the 1% redemption fee. Moreover, some load funds have become no-load funds. (J.A. 57). Thus, a buyer of a load fund which later became no-load would be exempt from any additional "value" created by the existence of a load at the time it was bought. If some no load fund were to become a load fund then the Government would presumably assert that those who bought the shares at no load must include the new load for estate tax purposes. And that is, of course, directly analogous to the situation in this case, where the decedent acquired the shares by gift, inheritance and by purchase at the bid price by investment of dividends and capital gains at no-load. (322 F. Supp. at 771).

Further, following this logic, an owner of shares in a load fund could claim the net asset value *plus* the load as a charitable deduction, if the shares were contributed to a charity, since Section 1.170-1(c) (1) uses the same fair market value test as the estate tax provision here at issue.[11] The Government has yet to allow such a claim.

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[11] With respect to deductions for charitable contributions and gifts, Regulation 1.170-1(c) provides that "If a contribution is made in property other than money, the amount of the deduction is determined by the fair market value of the property at the time of contribution."

After stating the willing buyer-willing seller test, the Regulation continues "If the contribution is made in property of a type which the taxpayer sells in the course of his business, *the fair market value is the price which the taxpayer would have received if he had sold*

Also, if the no-load fund shares are bought through a broker who charges the normal commission charge (as some do) that is not considered as part of the shares' "value" for estate tax valuation purposes, but a load fund with no redemption charge has its load added as a component of its "value" to the estate.

The no-load situation again demonstrates the true nature of the fund investment. The only real distinction in terms of rights or obligations between load and no-load funds is the imposition of a sales charge for the load fund, a sales charge which the fund never sees. To impose this additional burden on load fund shareholders unfairly discriminates against them (as against shareholders in no load funds, closed-end investment companies, corporate stock and bond holders), without any reasonable basis, and is inconsistent with the treatment of stock valuation in other reasonably analogous situations.

In this connection, the Government seeks to analogize the instant situation to a new issuance of stock offered to the public through an underwriter, where the issuer receives the amount paid by the purchaser, less the underwriting spread or cost. (Pet. Br. 11, n. 8). The underwriting cost, it is pointed out, is reflected in the public offering

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the contributed property in the lowest usual market in which he customarily sells . . ." (Emphasis added.) The regulation does not state that the fair market value is the price which the taxpayer would have to pay to purchase similar property—(i.e., replacement value). Instead the regulation states that fair market value is the price which the taxpayer would receive if he were to sell it in the normal way in which that product is sold.

Since the normal and customary way in which the securities in question are "sold" by a taxpayer is through redemption, consistency with tax regulations concerning determination of fair market value in other situations requires that the price at which the taxpayer can sell his shares, and not their replacement cost, be viewed as the fair market value for estate tax purposes.

price, even though the issuer does not retain that cost. "If the shares of a new issue are required to be valued for tax purposes *before a trading market for the securities has been established* . . . it could hardly be argued that underwriting fees which are included in the public offering price should be eliminated in determining the fair market value of the securities." (*Ibid.*). (Emphasis added).

The analogy breaks down at the threshold because a market for the sale and redemption of the fund shares here in question has been established for many years. Although there is a continuous offering involved in the sale of fund shares, it cannot be reasonably said to resemble the situation in the over-the-counter market on the effective date of a new issue. The SEC in its 1966 mutual fund report specifically found that " . . . the distribution of fund shares bears little similarity to conventional underwritten offerings of equity securities."[22] (The SEC's Special Study made the same point. See quoted material, *supra*, p. 10).

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[22] Report of the SEC on Public Policy Implications of Investment Company Growth, H. Rep. No. 2337, 89th Cong., 2d Sess. (1966) at 213. More fully, the SEC's PPI Report states:

> Conventional underwritings involve the distribution of substantial blocks of securities within fixed and extremely limited time periods. The major portion of underwriting spreads is devoted to compensating members of underwriting groups for the intensive promotional and selling efforts required. Often the securities are being offered to the public for the first time, and the underwriters have to arouse investor interest in an unknown security. Even where the underwritten security is already known to the investing public, the underwriters must dispose of a block of securities which is extremely large in relation to normal trading volume within a relatively short period and in a manner which does not significantly depress the price in the trading markets. Toward this end they may risk their capital in attempting to stabilize the market price of the shares during the distribution.
>
> Underwriters also assume other risks. Not the least among these are reputation risks. If the post-distribution performance

The fact is, as we have noted, *supra,* pp. 16-17, that as soon as a trading market develops, corporate shares can be sold by the investor in the market only through a broker

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of the underwritten security is poor, the underwriters may lose customers. Underwriting group members run the risk that if they are unable to sell their allotment of shares, they may not be asked to join in subsequent underwritings.

Moreover, in firm commitment underwritings the underwriters are obligated to buy and to pay for the underwritten securities on a specified date, regardless of whether they are able to complete the distribution by that date. If the entire issue is not sold within the time limit, the underwriters must invest their own capital in the issue—sometimes for a considerable period. And if, subsequent to the termination of the underwritten distribution, they ultimately sell a portion of the issue at prices below those paid to the issuer, they may suffer a loss on the underwriting.

Underwriters do not assume this risk in underwritings conducted on a "best efforts" basis. In these, if the underwriters are unable to complete the distribution, they are not obligated to buy the underwritten securities from the seller. However, best efforts underwritings of conventional securities have little relevance to a comparison of underwriting spreads with mutual fund sales loads. Underwritings of seasoned securities—to which mutual fund shares compare in quality—are almost always on a firm commitment basis.

Small portions of underwriting spreads also compensate the investment bankers that manage the underwriting groups for selecting the securities for distribution from the various proposals presented to them, negotiating the terms and conditions of the offering with the sellers, investigating the issuers and organizing underwriting syndicates and selling groups of broker-dealers.

As noted in chapter II, distributions of mutual fund shares are classified for some purposes like conventional underwritings. Those who manage the distribution of fund shares are called "principal underwriters" and, like the spreads in conventional underwritings, mutual fund sales loads are expressed as a percentage of the offering prices rather than as a percentage of the amounts invested. Nevertheless, the distribution of fund shares bears little similarity to conventional underwritten offerings of equity securities.

Mutual fund distributors are not concerned with raising a specific amount of money within a limited time by selling a

(direct sales are rare) who charges a commission for the sale (and purchase) which commission cost is not included in the value of the shares for valuation purposes. The Government's strained analysis asks the Court to believe that fund shares, which have been sold years before and for which the fund and its distributor have continuously maintained a market to redeem (purchase back) such shares at their current net asset value, are similar to a corporate new issue underwriting before a trading market has developed. That such a view bears no reasonable relation to the realities of the situation and cannot be sustained is made clear by the SEC's own Reports, *supra.*

The only real value the estate can realize is the redemption value, not the retail price. As the court of appeals noted, if the retail price of a property is an "unreasonable or unrealistic value standard" then it need not be followed

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stated quantity of securities to the public. They continuously sell as many shares of the funds they serve as they possibly can. Although both mutual fund and conventional underwriters bear business risks, mutual fund underwriters assume neither the reputation risks nor the capital risk inherent in conventional firm commitment underwritings. They sell in a price-protected market, since no dealer, whether or not a member of the selling group, may sell shares to the public at less than the current offering price described in the prospectus. And, since the offering price fluctuates as the net asset value of the fund's shares changes and since the fund redeems outstanding shares at current net asset value, the principal underwriter is never called upon to risk its capital in stabilizing the price of a fluctuating security.

Nor does the principal underwriter of a mutual fund bear the expense of selecting securities for distribution and of negotiating the terms and conditions of each offering as does the conventional underwriter. Unlike the underwriting spread, the mutual fund sales load pays only for the continuous promotional efforts of principal underwriters and for the continuous sales efforts of those who retail fund shares to the public. (Footnotes omitted).

in valuation disputes "as the sole criterion of value." (457 F.2d at 571).

The retail standard is certainly an "unreasonable or unrealistic value standard" in this situation and the Government's insistence on its application is unreasonable and inequitable. It imposes a burden on the redeemability of mutual fund shares which unfairly discriminates against fund shareholders and is contrary to the policy implicit in Section 22(e) and the other provisions of the 1940 Act, as well as the existing valuation standards applied by the Government in analogous situations.

CONCLUSION

For the foregoing reasons the judgment of the court of appeals should be affirmed.

Respectfully submitted,

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